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FROM: S D KING
DATE: 12 MARCH 1986

1. MISS O'MARA MOM 13/3
2. CHANCELLOR OF THE EXCHEQUER

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Economic Secretary
Minister of State
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Mr Monck
Mr H P Evans
Mr Odling-Smee
Mr Scholar
Mr Culpin
Mr S Davies
Mr Riley
Mr Dyer (+1 for No. 10)
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SIMON AND COATES MARCH FORECAST

Simon and Coates' latest bulletin will be published at 00.01am on Friday 14 March. Apart from the forecast, the bulletin contains the text of a lecture delivered by Gavyn Davies at the University of Ulster entitled 'Where economists now agree', and an article on the likely content of the Budget and the medium term policy implications given lower oil prices. A summary of the latter is attached.

Assumptions

2. S&C's forecast is based on an average oil price of $19/bl and an effective exchange rate averaging 72-73.

3. S&C assume tax cuts of around £½-1 billion and a PSBR outturn of £8½ billion in 1986-87 above a £7¾ billion target.

4. MO growth is assumed to be broadly in line with MTFS targets, although £M3 is expected to exceed existing government targets into the medium term.

Forecast

5. S&C

(except where specified, figures are percentage changes on previous year)

(last months's forecast in brackets)

	1986		1987	
GDP*	2.4	(2.1)	2.6	(2.3)
Consumers' expenditure	3.8	(3.6)	3.4	(3.1)
General Government Consumption	1.0	(1.0)	1.0	(1.0)
Gross Fixed Investment	2.7	(2.7)	2.8	(2.8)
Exports	2.6	(2.1)	3.5	(3.2)
Imports	3.9	(3.9)	4.4	(4.4)
RPI (Q4)	3.5	(3.5)	4.8	(5.0)
Unemployment (UK adults, million, Q4)	3.07	(3.03)	2.97	(3.00)
Current Account (£bn)	3.5	(2.8)	2.6	(2.4)
PSBR (financial year, £bn)	9.3	(9.3)	9.0	(9.0)

* output measure

6. The main points of the forecast are:

(a) Retail prices inflation falling to 3½ per cent by 1986Q4 helped by lower oil prices. However, from then the rate of inflation is expected to rise steadily to reach 4¾ per cent by 1987Q4 following unit cost pressures, and a slight decline in sterling (again, through lower oil prices).

(b) GDP growth of 2½ per cent in 1986 (up from 2¼ per cent last month) and a further 2½ per cent in 1987.

(c) Unemployment forecast in 1986Q4 of 3.07 million. Although slightly up on last month, it has been revised down by almost ½ million since April 1985. However, S&C expect unemployment under 3 million in 1987Q4.

(d) Base rates to reach a peak of 13 per cent in 1986Q1 before declining to an average 11½ per cent from 1986Q3 onwards. The effective exchange rate is expected to peak at 75.3 in 1986Q2 before falling gradually to 71 in 1987Q4.

UK Economic Commentary - The Budget

7. S&C assume that the Budget proposals will be based on a Treasury oil price assumption of $15/barrel, giving a PSBR 'target' of around £7¾ billion in 1986-87 and scope for around £½-1 billion in tax cuts. This assumes that the fall in oil revenues from the levels forecast in the 1985 FSBR will be partially offset by increased non oil revenues, (notably CT revenues £1½ billion higher than at the time of the Autumn Statement) and here, they maintain, they are more optimistic than other forecasters.

8. S&C give a summary of likely Budget measures. They suggest tentatively complete indexation and on top of that a reduced rate band, halving of stamp duty, new taxes on financial services and 'windfall earnings', a NIC package, employment measures and an increase in petrol duty above revalorisation. They look for an MO target range of 2.6 per cent and a money GDP "illustration" target of 6½ per cent but no new £M3 target range.

Response to oil price fall

9. S&C emphasise the supply side benefits of the oil price fall. They see a trade off between a permanent inflation gain and a temporary output gain but, with unemployment high in the UK, believe the Government will opt for higher output over the short term. This implies allowing a real exchange rate fall and ensuring the benefits are not choked off by an excessively tight monetary policy. S&C advocate effectively replacing monetary targets by a unit cost target. Given the favourable supply side effects stemming from the oil price fall and the fact that higher taxation of the non-North Sea sector in substitution for the loss of North Sea tax revenue is likely to have a greater effect on economic activity, S&C suggest government borrowing (as measured by the PSFD) should act as a shock absorber and be allowed to rise. But they note that the PSFD has already increased by £3 billion since the 1985 Budget and would therefore keep it at its current level, implying a PSBR below £8 billion.

10. S&C give their usual assessment of the likely course of the MTFS in the next few years. First they give "targets" for the PSBR which they feel are likely to be set in the FSBR. For 1986-87, they have £7¾ billion which they think, with the help of oil prices above $15 the Government has a reasonable chance of meeting. For the next two financial years, they set the PSBR at £7 billion. However, with buoyancy in revenue not expected to offset overshoots in public expenditure, S&C expect PSBR outturns of £8½ billion, £8 billion and £8½ billion respectively.

Lecture Text - 'Where economists now agree'

11. This lecture highlights some of the theoretical and policy making disputes of the late 1970s, and argues that there is now a greater degree of consensus in the economics profession. There are six major areas in which Davies argues there is substantial agreement

(a) the operation of monetary targets is not, in itself, sufficient for macroeconomic policy: the relation between money and national income is imprecise, and money is difficult to define and control

(b) some form of nominal target should should be set by the Government (eg nominal GDP, unit costs, or sterling exchange rate)

(c) there is a role for fiscal policy to assist in hitting the chosen nominal target

(d) inflationary shocks should not be accommodated by the Government

(e) wages are important in determining the levels of employment and unemployment - the Government has 'allowed' unemployment to rise simply in order to keep inflation (attributed to an accommodating stance toward wage bargaining between unions and oligopolistic firms) in check

(f) Government attempts to stimulate demand should take account of the supply side of the economy.

12. However, Davies believes that no major consensus has been reached over unemployment. He rejects the argument that because the labour force has been growing very rapidly unemployment has increased, since growth of this magnitude in the past has been accompanied by falling unemployment. He also rejects three further arguments. Technical change was, he argues, at least as rapid in the 60s and 70s, and yet unemployment did not increase as quickly. Though the world recession hit other countries, they did not experience the same rate of increase in unemployment as the UK. And whilst employment has risen substantially since 1983, there has been little change on a full time equivalent basis.

13. One possible explanation is that the replacement ratio is too high, preventing the real wage in the non-unionised sector from falling for enough to clear the market. But Davies claims that most studies show that the replacement ratio is too low to have any great influence. Davies' preferred explanation is that bargaining between unions and firms increases the likelihood of inflation at any given level of output, thus raising the NAIRU. Davies recommends that the Government should do something to influence the bargaining behaviour (an incomes policy, or profit sharing, for example), especially when a pool of long term unemployed is assumed to be effectively out of the labour market, and thus unable to

affect the wage bargaining process. Furthermore, Davies expresses concern that this pool, and thus the NAIRU, may tend to rise if the economy is slow to adjust from an initial disequilibrium position and if the actual level of unemployment is above the NAIRU. He concludes by lending support to the House of Commons Select Committee on Employment, and says that their package is about 'ten times more cost effective per job ... [than] income tax cuts.'

Lines to take

14. Prospects: S&C's GDP forecast for 1986 up from 2 per cent last month to 2½ per cent, and far higher than the ¾ per cent forecast they were giving in February 1985, S&C forecast sustained growth to continue through 1987 and 1988. Inflation forecast to be 3½ per cent by 1986Q4. S&C expect unemployment to fall below 3 million in 1987. All in all suggest increasing optimism over the performance of the economy.

15. On S&C's assessment of likely Budget measures. Wait till Budget.

16. Government has an inflation 'target'. Aim is to maintain steady downward pressure on inflation. Price stability remains ultimate objective.

17. Problems with monetary targets? Not so. Necessary to look at range of monetary indication. Conflicting signals. On balance policy firm but not excessively tight. And look at achievements. Inflation 5.5 per cent and falling; fifth successive year of economic growth.

18. Should use unit cost target? No. Davies admits that Government cannot control unit costs. Simply reflects Davies' belief that inflation generated by wage pressures, not loose monetary policy. Government sees link between pay and jobs.

19. Should use nominal GDP target? Practical obstacles: data arrive late, and liable to revision; nominal GDP takes time to respond to policy changes.

20. Fiscal policy has been relaxed Chancellor has adopted a permanent income approach? Fiscal policy is prudent. PSBR is low. Privatisation not pursued to disguise 'relaxed' fiscal stance, but to encourage supply side benefits of enterprise and efficiency.

21. Role for fiscal policy in hitting nominal targets? Fiscal expansion will ultimately lead to crowding out. Low PSBR will, however, provide microeconomic supply side benefits.

22. PSBR a garbage statistic? Ridiculous claim. PSBR only measure of fiscal stance available on a timely basis.

23. S&C agree with Government that inflationary shocks should not be accommodated, and that wages are important in determining the level of unemployment.

24. Government has 'allowed' unemployment to rise? Nonsense. More realism on wages required by employers and employees if unemployment is to come down. A more accommodating policy would, as Davies admits, only let inflation rise again, with disastrous long term consequences for both output and unemployment.

25. Recent rise in labour force not unprecedented? Labour force rose by 510,000 in 1984. Largest rise in single year since figures began to be collected.

26. On a full-time equivalent basis, little change in number of jobs since 1983? Full-time equivalent calculation fraught with uncertainty. Around 600,000 more people in work since June 1983 and no evidence that bulk of them work particularly short week. Davies like others omits self-employed.

27. H of C Select Committee's measures ten times more cost efficient per job than income tax cuts? Takes no account of supply side benefit of tax cuts in terms of incentives and improved efficiency.

28. Long term unemployed do not affect wage bargaining. No conclusive evidence on this. Therefore imprudent to take policy measures assuming that they do not.

Stephen King

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Simon & Coates

The Economics Analyst

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Information: *Chief Economists:*
Gavyn Davies (UK) *Work: 01-588 3644* *Home: 01-691 2077*
David Morrison (International) *Work: 01-588 3644* *Home: 01-541 0214*

PUBLIC SECTOR BORROWING AFTER OPEC III

1. This will not be a Budget in which Mr. Lawson can make a major splash as a tax-cutter or a tax-reformer. Exactly how he re-shuffles the tax system will be of only passing interest from a macro-economic standpoint, though individual tax changes may have important market implications. (Our own guesses about the likely package appear on pp2—4.) Much more interesting this year are the major strategic issues raised by the oil price crash, and the financial markets should judge Mr. Lawson mainly on whether his medium term plans successfully come to grips with the new situation.

2. Essentially, the Chancellor needs to re-cast the MTFS to take account of the new world, post OPEC III. Even if the Treasury forecast is based on some bounce-back in oil prices, government revenues from the North Sea in 1986/87 are likely to be less than half of the £11½bn expected a year ago (see table overleaf). The big question is: how much of this, if any, should be added to government borrowing?

3. There are four reasons why it is legitimate for government borrowing to rise in response to reduced oil revenues. These are:

   (i) ***Demand Effects.*** Oil revenues have a lower short-term impact on demand than other forms of government revenue. A simple replacement of oil receipts by increased taxation elsewhere therefore depresses the economy — something which is entirely inappropriate in view of the supply-side gains which the onshore economy will enjoy as a result of lower energy costs. This can only be avoided by allowing borrowing to rise, perhaps by about £4bn relative to plans made this time last year.

   (ii) ***Public Sector Balance Sheet Considerations.*** In order to leave the net worth of the public sector constant, the government should "consume" through lower taxation only that portion of the oil revenues in excess of the ***permanent*** increase in revenue to be derived from oil. The likely excess of actual revenue over permanent revenue has fallen by £4—5bn since the 1985 Budget plans were published; on public sector balance sheet considerations this should now be added to public borrowing in 1986/87.

   (iii) ***Absorbing The Shock.*** The loss of oil revenues should be partially offset in the long term by an increase in non-oil receipts as the growth performance of the onshore economy improves. Consequently, if tax ***rates*** are left unchanged from now on, public borrowing will initially rise in response to reduced oil receipts, but will then fall back as the non-oil economy expands. In these circumstances, it is legitimate to allow a short-run increase in borrowing as the economy adjusts to lower oil prices. The alternative is to allow a temporary increase in tax ***rates*** in order to stabilise public borrowing. But this is surely more de-stabilising for the private sector than accepting a temporary rise in borrowing.

   (iv) ***Hitting the Money GDP Target.*** It is now increasingly agreed by economists from all sides that fiscal

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policy changes have a role to play in ensuring that money GDP targets are achieved. The existing target for money GDP growth in 1986/87 is 6½%, and on our forecast this seems likely to be ***undershot*** by about 1%. It would almost certainly be missed on the low side by an even wider margin if the fiscal stance is now allowed to tighten (see above). Some easing in the fiscal stance, ***as well as*** the downward shift in the 'invisible' exchange rate target which has already occurred, therefore appears legitimate. In order to achieve this combination, it may be important to ease monetary policy by cutting ***interest rates*** immediately after the Budget. Otherwise undesirable upward pressure might develop on the currency.

4. These factors suggest that, ***in order to achieve the same ultimate objectives set for the economy a year ago***, the Chancellor would need to increase public borrowing relative to the targets announced in March 1985. These targets were £7½bn for the PSBR and an implied £9½bn for the PSFD (the public sector financial deficit). From now on, it is sensible to concentrate ***only*** on the PSFD, since the PSBR total can be massaged to any extent the Chancellor chooses by varying the path for privatisation receipts. (For example, there is at least £2—3bn of flexibility in this year's PSBR projection to be derived by varying the timing of British Gas receipts and the subsequent payment to the Exchequer of the loan stock which BGC is rumoured to be raising after privatisation.) ***In consequence, the PSBR is now an economically irrelevant statistic*** (though it does of course determine the level of gilt sales).

5. Concentrating on the PSFD, the above arguments suggest that an increase from £9½bn to about £14bn would be necessary to achieve the same ultimate economic objectives that were set a year ago. How likely is it that Mr. Lawson will contemplate such an increase? At first sight, it might seem wholly implausible. Yet the Chancellor has already moved a long way down this road in the past 12 months — he has simply disguised the shift by increasing the privatisation programme, thus leaving the (economically irrelevant) PSBR unchanged. For example, if the PSBR target in the Budget is left at £7½—8bn, the planned receipts of £4¾bn from privatisation would leave the PSFD at around £12½bn, only £1½bn short of the "appropriate" target mentioned above. A small slippage relative to target could easily wipe out even this small margin.

6. Hence the government has already accepted the case for responding to reduced oil revenues by increasing the level of government borrowing. The only question is whether the Chancellor comes clean and admits this, presenting a clear rationalisation for what he is doing. If he does, the markets would probably be unruffled, accepting the new strategy as defensible, especially if the exchange rate and/or monetary targets are simultaneously beefed up. On the other hand, if the Chancellor tries to disguise what he is doing — attempting to focus attention on a garbage statistic such as the PSBR — he will deserve and receive less long-term respect from the markets.

Table 1: Possible Changes Between 1985 and 1986 Budgets (as forecast on pp2—4)

£bn	Projections for 1986/87 made in: 1985 Budget	1986 Budget (forecast)	Change
1. Oil Revenues	11.5	5.0	-6.5
2. Underlying Non-oil Revenues	147.5	151.5	4.0
3. Tax Cuts	3.5	0.75	-2.75
4. Total Non-oil Receipts	144.0	150.75	6.75
5. Total Receipts	155.5	155.75	0.25
6. Total Expenditure (excl. asset sales)	166.0	169.25	3.25
7. Public Corp. Borrowing	-1.0	-1.0	0
8. PSFD	9.5	12.5	3.0
9. Asset Sales	2.0	4.75	2.75
10. PSBR	7.5	7.75	0.25

11 March 1986